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ABSTRACT

This report examines state earned income tax credits (EICs) as a means to assist working poor families to escape poverty. Specifically, the report notes that six states have their own EICs, expressed as a percentage of the federal EIC, with the advantages being that the credit is a reward for work, is a pro-family policy, is efficiently targeted, prevents states from taxing families deeper into poverty, and offsets the effects of regressive state and local taxes. Following a summary and introduction in Chapter I, chapter II, entitled "Poverty and Work", reviews the extent to which work alone no longer alleviates poverty and covers the education-related subject of "child poverty". Chapter III examines the structure of the federal EIC and the role it plays in helping to "make work pay." Chapter IV examines the purposes that a state credit serves and the key decisions in designing a credit. Chapter V takes a closer look at the need to improve state tax progressiveness and the role of a state EIC. Chapter VI discusses the need for outreach to eligible families once a credit is enacted. Chapter VII describes the legislative and political processes by which EICs became law in Wisconsin and Maryland. Included are five graphs and eight tables. An appendix provides information on calculating the state revenue impact of an EIC. Forty-four footnotes are included. (JB)

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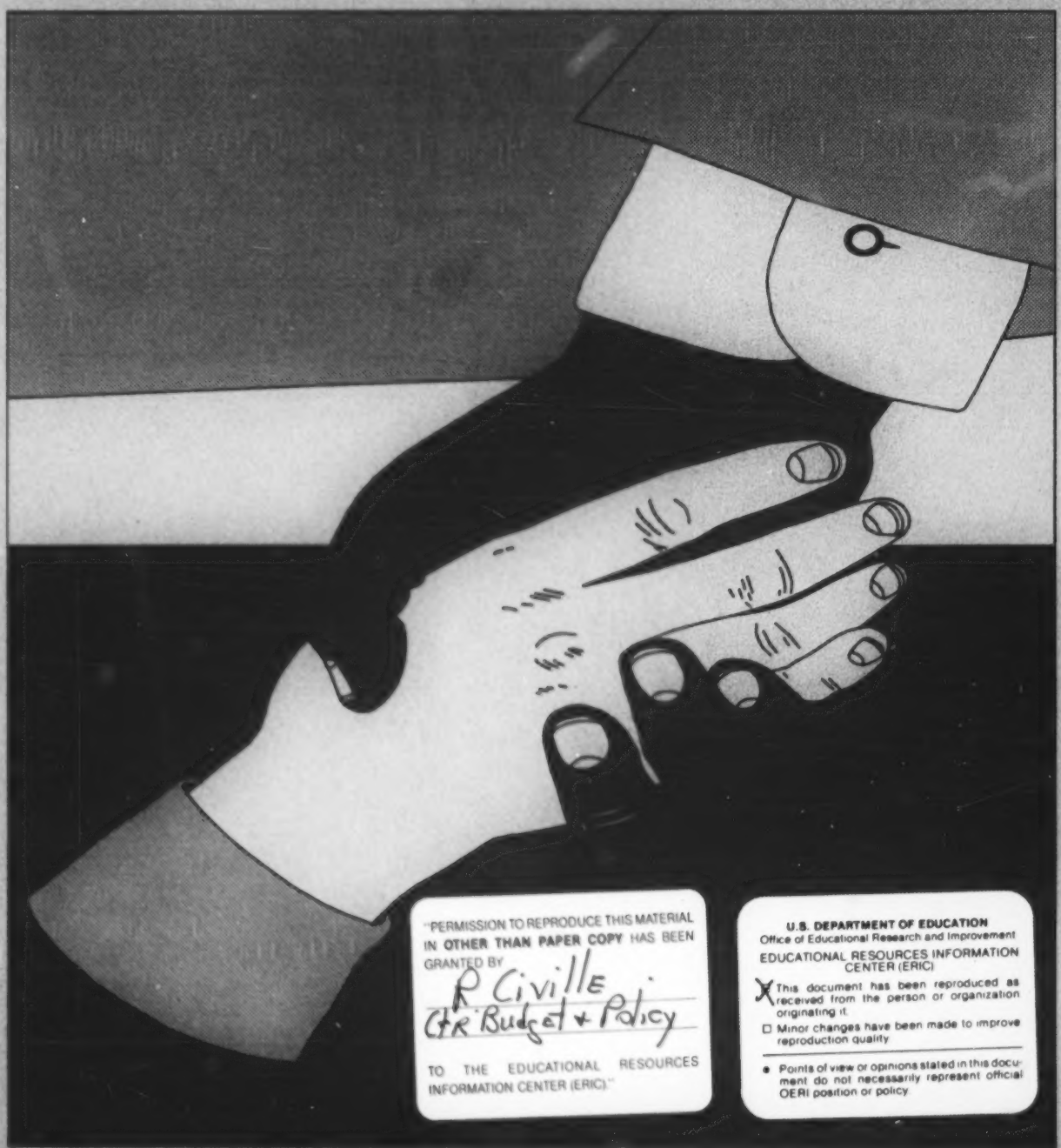

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How State Earned Income Credits Help Working Families Escape Poverty

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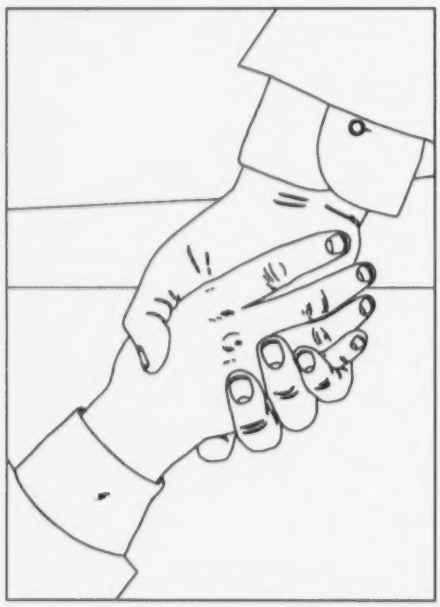

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Summary

In 1992, a parent with steady work often cannot lift a family out of poverty. Full-time, year-round work at the minimum wage, for example, pays only 78 percent of the poverty line income for a family of three. For a family of four, it comes to a little more than 60 percent of a poverty income. This means that children may grow up poor even if parents are trying hard to make a living.

One strategy to 'make work pay' enough to lift a family out of poverty has been supported by both liberals and conservatives. It is the earned income tax credit, a federal provision that has been incorporated into several state tax systems as well. Further proliferation and expansion of state-level earned income credits would contribute significantly to the goal of making work pay.

The federal earned income credit helps low- and moderate-income families with children. Created by Congress in 1975, it is designed to:

- offset the social security payroll tax burden;
- supplement low earnings;
- promote work as a viable alternative to welfare.

The credit is attractive to policymakers across the political spectrum because it promotes the work ethic and family values. It has been a key feature of proposals to assist the working poor. The EIC was expanded both in the Tax Reform Act of 1986 and as part of the budget agreement negotiated by Congress and the President in 1990.

The most recent expansion is estimated to lift an additional 1.2 million people out of poverty by 1994. But it still is not sufficient. Families with minimum wage income — even supplemented by the federal EIC — will remain in poverty. State EICs can help fill that gap.

State Earned Income Credits: Their Function and Purpose

Six states — Iowa, Maryland, Minnesota, Rhode Island, Vermont, and Wisconsin — have their own EICs, expressed as a percentage of the federal credit. State earned income credits are good policy for states for the same reasons they are good policy at the federal level.

- As a *reward for work*, an earned income credit can help bring the wages of poor families up to or slightly above the poverty level. By doing this, an earned income credit can enhance state efforts to decrease reliance on welfare.

- As a *pro-family* policy, an earned income credit available to two-parent families as well as single-parent families could encourage families to remain together. It rewards low-income working parents who live with and care for their children.

- As *efficiently targeted* tax policy, a state earned income credit is less costly than other means of achieving similar goals through the tax code.

Two additional advantages make earned income credits particularly appropriate state policy.

- Earned income credits can *prevent states from taxing families deeper into poverty*. Some 24 of the 42 states with income taxes still tax significant numbers of working poor families. This contrasts with the federal system, under which families with incomes below the poverty level do not have income tax liability. An earned income credit can raise the income at which poor families with children begin to owe tax, and so prevent a state from reducing their already meager wages.

- Earned income credits can *offset the effects of regressive state and local taxes on the poor*. Most states rely on sales and excise taxes that consume a larger share of the income of low-income families than of high-income families. A refundable earned income tax credit can offset the regressive effects of these taxes on working poor families with children.

At the state level, earned income credits are relatively new. Five of the six states using EICs adopted them since passage of the 1986 federal tax reform act.

How the Federal EIC Now Works

In tax year 1992, families with children who have incomes up to $22,370 are eligible for the EIC. The credit now has three components: a basic credit, a young child supplement, and a health insurance credit.

- All eligible families receive a basic credit. The amount of the basic credit increases with family earnings until earnings reach $7,520. Families with earnings between $7,520 and $11,840 receive the maximum credit, which is $1,324 in tax year 1992. The maximum credit amount then phases down slowly as income rises until it vanishes at $22,370 of income.

- EIC families with a child under one year of age are also eligible for the young child supplement, which is a maximum credit of $376 in 1992.

- EIC families that pay premiums for a health insurance policy that covers a child can also receive the health insurance credit, up to $451 in 1992.

The federal EIC is refundable. This means that a family receives the full amount of the credit, even if the credit amount is greater than the family's income tax liability. The amount by which the credit exceeds taxes owed is paid as a refund. If a family has no income tax liability, the family receives the entire EIC as a refund.

Establishing a State EIC

State EICs generally conform to federal provisions. But there are four decisions to be made when considering a state EIC:

- whether to make the credit refundable;

- whether to adjust the credit for family size;

- whether to conform to the total federal EIC or the basic federal EIC; and

- the percentage of the federal EIC at which the credit will be set.

Refundability

While the federal credit is refundable, state EICs may be either refundable or non-refundable. Minnesota, Vermont, and Wisconsin have refundable credits; Iowa, Maryland, and Rhode Island have non-refundable credits.

- A *non-refundable* tax credit reduces the amount of tax that a family owes until either the credit amount has been exhausted or the income tax bill has been reduced to zero. In states that tax the working poor, it can be an inexpensive way to target tax relief to low- and moderate-income working families. Non-refundable state EICs do not supplement wages or offset the regressive effects of other state and local taxes.

- A *refundable* earned income credit can serve a wider variety of purposes. In states that already exempt most of the poor from income tax, refundable EICs supplement the income of poor families with children that work for most or all of the year. They also can provide relief from sales and excise taxes.

Family-Size Adjustments

The 1990 federal expansions added a small family-size adjustment to the EIC. When the expansions are phased in fully, the maximum benefit for families with two or more children will exceed the benefit for a family with one child by only $160. By contrast, the poverty line rises more than $2,000 for each additional child. States must decide whether to accept or augment the federal adjustment.

- A state simply conforming to the federal credit will have a tiny family-size differential. For example, if a state credit equals 20 percent of the federal EIC, the maximum state EIC for a family with two or more children will exceed the credit for families with one child by $32.

- Wisconsin is the only state that varies the percentage of the federal credit allowed by family size. By 1994, the state credit for a family with three or more children will exceed the credit for a family with one child by more than $1,400.

The Basic Credit vs. the Total Credit

Five of the states with EICs express their credits as a percentage of the total federal EIC, which includes the supplemental credits for a child under one year of age and for premiums for health insurance that covers a child. One state, Wisconsin, expresses its EIC as a percentage of the federal *basic* EIC.

- There is no strong policy reason for states to adopt the supplemental credits. States tying to the basic federal EIC will distribute benefits more evenly among low-income families with children. For any given level of state expenditures, less will go to families who fit the special circumstances of the supplemental credits, and more to all other low-income families.

- There may be administrative problems for states that conform solely to the basic benefit. If families are deterred from claiming their state EIC because they do not know the amount of their basic federal EIC, the advantage of spreading EIC benefits more fairly and more broadly would be canceled. States can overcome this problem by calculating the state EIC benefit for families that file the federal Schedule EIC with their state tax return.

Cost Considerations

States have designed credits that range from 6.5 percent to 50 percent of the federal EIC. States can put their credit within desired cost limits by adjusting this percentage.

The Need for Outreach

Earned income credits have a high participation rate. Some 80 to 90 percent of eligible families appear to receive the federal credit. State EICs have high participation rates as well, albeit not as high as the federal.

Significant outreach efforts need to accompany state EICs for two reasons.

- There are still a number of eligible working poor families with children who do not receive the federal EIC, often because they have no income tax liability and do not file a tax return to claim the EIC. This number could rise significantly as a result of complexities in the federal filing process starting in 1992.

- Some families receiving the federal EIC may not know the amount of their federal benefit because the Internal Revenue Service computes it for them. They may not be able to enter their federal EIC amount on their state income tax return.

States instituting EICs can undertake a variety of outreach strategies to address both of these problems. Low-income working families may be alerted to file for

benefits through other benefit or service programs, in stores where they shop, at businesses where they work, or through the media. Taxpayer assistance programs, informational material, and hotlines may help families make the necessary computations.

The EIC as an Effective Policy Option in the Fight Against Poverty

Earned income credits can be effective in the fight against poverty, including the growing problem of child poverty.

- In 1989, the peak of the longest economic recovery since World War II, child poverty was higher than any year of the 1970s, including the deepest recession years of that decade. The average child poverty rate was higher during the 1980s than during any sustained period since the early 1960s.

- As the recession began in 1990, the child poverty rate rose to 20.6 percent. A further large increase is expected in 1991.

Child poverty has grown in part because more *working* families are poor.

- The poverty rate for working families with children climbed from 8.6 percent in 1979 to 11.3 percent in 1990. This represents an increase of nearly *one-third.*

- In 1990, approximately 8.2 million poor children — nearly two of every three — lived in a family where a household member worked. Nearly three million poor children lived in a household with a full-time year-round worker.

Reasons Behind the Rise in Child Poverty

Declining wages have prevented working families from escaping poverty.

- Labor Department data show that after adjustment for inflation, average hourly wages paid to non-supervisory workers were lower in 1991 than in any year since 1963. Wages for these workers fell even during the recovery of the 1980s.

- Economist Rebecca Blank found that poverty declined less during the recovery of the 1980s than during the recovery of the 1960s, even though low-income households increased their employment levels *more*

in the 1980s than in the 1960s. She found that wage erosion canceled a significant part of the gains from increased employment.

Welfare policy has also changed, making it more difficult to escape poverty by working.

- Families earning below-poverty wages are far less likely to qualify for AFDC benefits to supplement their low earnings than they were a decade ago. In 1972, a mother with two children and wages equal to 75 percent of the poverty line could receive some AFDC benefits in 49 states to lift her closer to or above the poverty line. In 1980, she would have been eligible in 42 states. By 1991, she could get AFDC in only five states.

- The Manpower Demonstration Research Corporation has found successful welfare-to-work programs generally raise family income much less than they raise employment rates. Low wages mean that welfare families that go to work frequently lose nearly as much in public assistance as they gain in earnings.

Policy Options

The problem of making work pay enough to lift a worker's family out of poverty could be addressed in a number of ways:

- Restoring the purchasing power of the federal minimum wage to its average level in the 1960s and 1970s would help significantly, but would still leave a substantial gap between wages and the poverty line for larger families.

- States can raise their own minimum wages above the federal level, as 17 did in the latter part of the 1980s. Today, seven states have minimum wages above the federal level.

- Changes also could be made in AFDC programs to allow a more gradual reduction in benefits until wages and benefits reached the poverty level. Many states, however, are moving their AFDC programs toward less adequate benefits.

Among these options, state earned income credits are a specific, targeted approach to making work pay. As an addition to the federal credit, they can help close the gap between earnings and a living wage — at a very modest cost.

I. Introduction

The federal earned income credit is a tax credit for low- and moderate-income families with children. It is designed to offset the adverse effects of the Social Security payroll tax, to supplement the earnings of these families, to strengthen incentives to work, and to promote work as a viable alternative to welfare. At the federal level, the credit is popular across the political spectrum because it promotes the work ethic and family values. This broad-based popularity has made the EIC a key feature of proposals to assist the working poor. The EIC was expanded both in the Tax Reform Act of 1986 and as part of the budget agreement negotiated by Congress and the President in 1990.

Six states have their own EICs that conform with the federal credit — Iowa, Maryland, Minnesota, Rhode Island, Vermont, and Wisconsin. Five of these six states adopted EICs since passage of the 1986 tax reform act.[1]

A growing number of elected officials in other states are examining the possibility of establishing an earned income credit. As state tax policy, an EIC can:

- provide tax relief for working poor families;
- partially offset the impact of regressive sales and excise taxes on low-income working families; and
- function as an incentive that can boost the advantages of work over welfare.

[1] Rhode Island had an EIC prior to the Tax Reform Act of 1986 because of the way in which its income tax liability is determined. Rhode Island is one of three states in which income tax liability is a specified percentage of federal income tax liability. Rhode Island is the only one of these states that bases its calculations on federal tax liability *after* tax credits have been applied. Thus, Rhode Island effectively has a state EIC without explicitly acknowledging an EIC policy.

The EIC is increasingly regarded as both an important complement to welfare reform and an effective tool to help reduce poverty among children.

This report examines the dimensions of the earned income tax credit. Chapter II reviews the extent to which work alone no longer alleviates poverty. Chapter III examines the structure of the federal earned income credit and the role it plays in helping to "make work pay." Chapter IV examines the purposes a state credit serves, and the key decisions in designing a credit. Chapter V takes a closer look at the need to improve state tax progressivity and the role of a state EIC. Chapter VI discusses the need for outreach to eligible families once a credit is enacted. Chapter VII describes the legislative and political processes by which EICs became law in Wisconsin and Maryland. The appendix provides information on calculating the state revenue impact of an EIC.

II. Poverty and Work

A parent working steadily no longer means that a family will be able to live above poverty. Full-time, year-round work at the minimum wage, for example, now pays only 78 percent of the poverty line income for a family of three. For a family of four, it comes to a little more than 60 percent of a poverty income. This means that children may grow up poor even if parents are trying very hard to make a living.

Child Poverty

Poverty is more common among children than among any other age group; it is nearly twice as prevalent among children as among the elderly, the age category with the next highest incidence of poverty.[2]

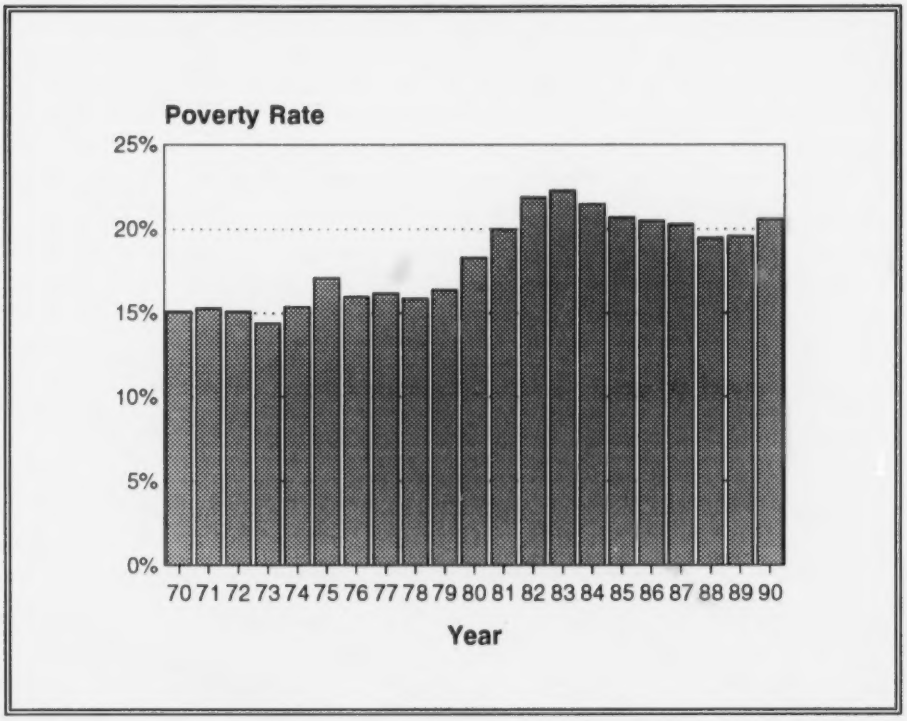
Poverty among children has grown significantly over the past decade.

- In the 10 years preceding the recession that began in 1990, the poverty rate among children increased from 16.4 percent to 19.6 percent.

- In 1989, the peak year of the longest economic recovery since World War II, the child poverty rate was higher than any year of the 1970s, including the deepest recession years of that decade. The average child poverty rate was higher during the 1980s than during any sustained period since the early 1960s.

[2] In 1990, the child poverty rate was 20.6 percent, while the poverty rate among the elderly was 12.2 percent.

Figure 1
Poverty Rate Among Children, 1970-1990



- As the recession began in 1990, the child poverty rate rose to 20.6 percent. A further large increase is expected in 1991 as a result of the economic downturn.

Child poverty rates remained high throughout the recovery of the 1980s. In fact, between 1979 and 1989 — two years that represent recovery peaks — child poverty grew nearly three times as much as the overall poverty rate,[3] and the number of poor children grew by 2.2 million.

Poverty Among Working Poor Families With Children

Child poverty has grown in part because more *working* families are now poor. The poverty rate for working families with children climbed from 8.6 percent in 1979 to 10.7 percent in 1984, and then to 11.3 percent in 1990. From 1979 to 1990, this represents an increase of nearly *one-third*.

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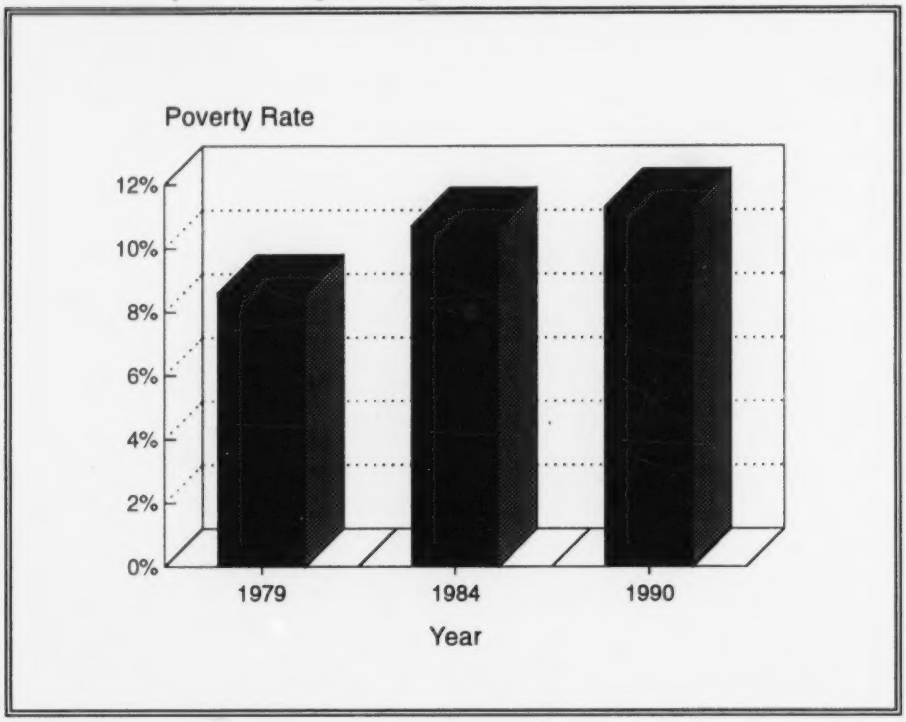
[3] Between 1979 and 1989, the proportion of the total population in poverty rose 1.1 percentage points, from 11.7 percent to 12.8 percent. During the same period, the proportion of children in poverty rose 3.2 percentage points, from 16.4 percent to 19.6 percent.

Figure 2
Poverty Rate Among Working Families With Children, 1979-1990



In 1990, approximately 8.2 million poor children — nearly two of every three — lived in a family with a working household member. Nearly three million children lived in a household with a full-time year-round worker.

Indeed, late in the economic recovery of the 1980s, the ranks of the working poor were growing even while overall poverty was declining. Between 1987 and 1989, the number of poor families with children with a full-time year-round worker rose 68,000, even while the total number of poor families with children dropped 157,000.

The Role of Declining Wages

These increases in the ranks of the working poor reflect significant economic changes during the past two decades. In the 1950s and 1960s, the economy grew at a rapid pace, and wages rose. Since the early 1970s, however, wages have stagnated or declined. Labor Department data show that after adjustment for inflation, average

hourly wages paid to non-supervisory workers were lower in 1991 than in any year since 1963. Wages fell even during the recovery of the 1980s.

Research by Rebecca Blank, an economist at Northwestern University who formerly served as a staff member of President Bush's Council of Economic Advisers, shows this wage erosion has had a strong effect on poverty rates. Blank found that poverty declined less during the recovery of the 1980s than during the recovery of the 1960s. This was true even though low-income households increased their employment levels *more* in the 1980s than in the 1960s. Blank attributes this to an erosion in wages in the 1980s that canceled some of the gains from the increases in employment. Her research indicates that wage erosion had a much larger impact on poverty rates in the 1980s than either budget cuts or increases in the proportion of families headed by a single female parent.[4]

The problems posed by this erosion in wages are heightened by an accompanying trend: the gaps between wages paid for low-paying jobs and those paid for average- and high-paying jobs have grown sharply. The decline in wages has been greatest on the lower rungs of the scale.

This drop in wages for low-paid work is of particular concern; not only does it increase poverty, but it can also make work less attractive. Economists believe many potential workers have what is called a "reservation wage" — a wage level below which they will not seek or accept employment. As wages drop below the reservation wage — if work does not pay what is necessary to live — the attractions of work lessen.

The Role of Welfare Policy Changes

Welfare policy has also changed over the last two decades in ways that make it more difficult to escape poverty by working. An analysis by the House Ways and Means Committee shows that families earning below-poverty wages are far less likely to qualify for Aid to Families with Dependent Children than they were a decade ago.

The analysis shows that in 1972, a mother with two children and wages equal to 75 percent of the poverty line could receive some AFDC benefits in 49 states. In

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[4] Blank's research compares the nine percentage point drop in poverty between 1961 and 1970, from 21.9 percent to 12.6 percent, with the 1.7 percentage point drop in poverty between 1983 and 1989, from 15.2 percent to 13.5 percent.

Table I
Number of States that Supplement Low Wages with AFDC

Mother with Two Children (and no child care expenses)

Wages equal	1972	1980	1991
50% of poverty	49	47	33
75% of poverty	49	42	5
100% of poverty	45	33	0

Source: House Ways and Means Committee

1980, she would have been eligible for AFDC in 42 states. By 1991, she could get AFDC in only five states.[5]

Federal legislation enacted in 1988 was designed, in part, to improve the skills and the work ethic of welfare recipients and move them into the labor market. But a growing body of research suggests that employment and training programs will have only modest effects unless accompanied by efforts to increase the financial returns from low-wage employment.

The Manpower Demonstration Research Corporation has found successful welfare-to-work programs generally raise family income much less than they raise employment rates. Low wages mean that welfare families that go to work lose nearly as much in public assistance as they gain in earnings. MDRC has noted that wage supplements such as the earned income credit are needed if welfare-to-work programs are to reduce poverty and increase the returns from low-wage work more significantly.[6]

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[5] These figures are for families with no child care expenses. The figures are similar, however, for families that do incur child care costs. A family of three with earnings equal to 75 percent of the poverty line, and with average child care expenses, qualified for AFDC in 49 states in both 1972 and 1980. In 1991, such a family could get AFDC in only 14 states. Committee on Ways and Means, U. S. House of Representatives, *Background Material on Family Income and Benefit Changes*, December 19, 1991.

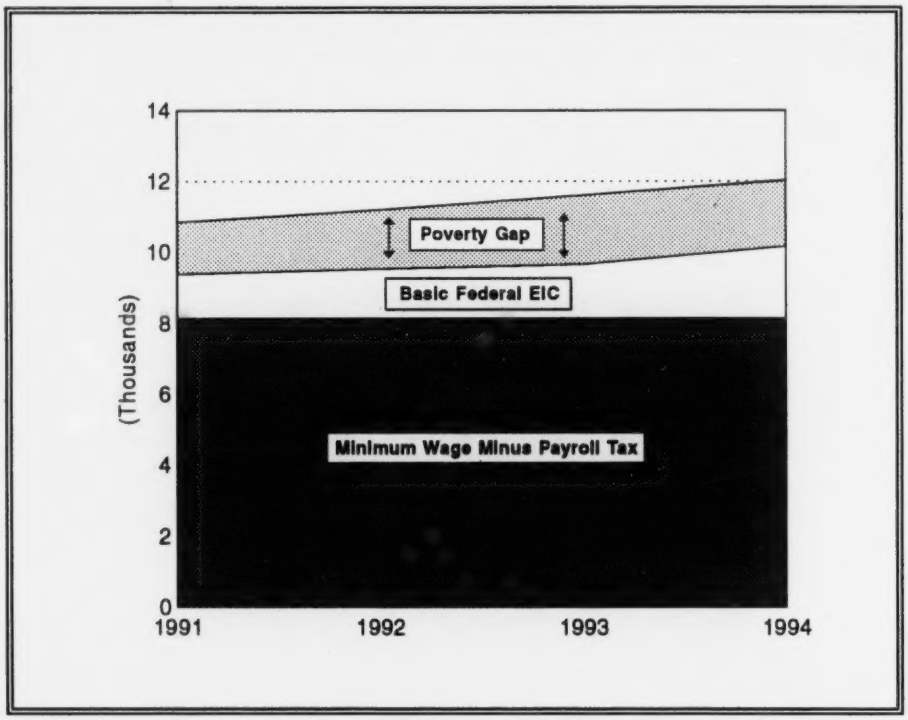
[6] Judith M. Gueron and Edward Paul, *From Welfare to Work*, New York: Russell Sage Foundation, 1991.

The EIC: Major Component in the 'Making Work Pay' Strategy

The federal EIC is central to a strategy to boost work incentives, make work more attractive than public assistance, and lessen poverty among working families with children. This strategy is sometimes referred to as a strategy to "make work pay." Beneath this strategy is a goal increasingly espoused by both liberals and conservatives: work should "pay" enough so that if a parent works full-time, year-round, the family will not be poor. Recent EIC expansions are expected to lift an additional 1.2 million people out of poverty by 1994. But the federal EIC is still not a sufficient answer to this problem.

A family of three with a full-time minimum-wage worker will still be $1,669 below the poverty line in 1992 even after the EIC is taken into account. A family of four will be $4,834 below the poverty line.[7] Even though the EIC will be increasing

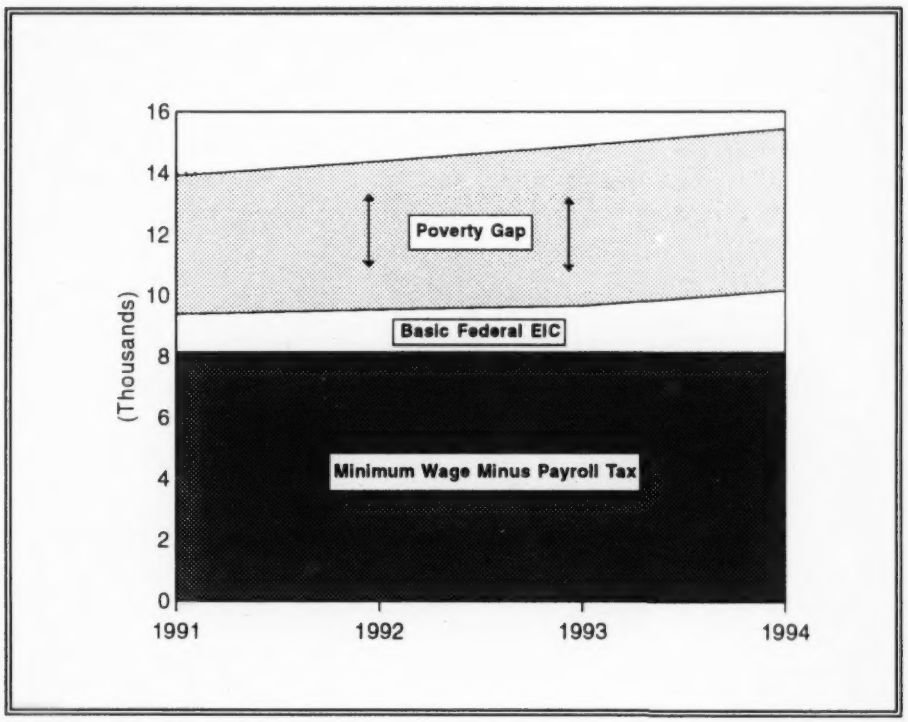
Figure 3
Poverty Gap For Working Family of Three
With Two Children



[7] This counts the minimum wage less payroll taxes plus the EIC, using the basic EIC benefit for a family with more than one child. A family with minimum-wage earnings would receive an additional $376 if it had a child under one year of age, and up to an additional $451 to reimburse premiums paid for a health insurance policy covering a child.

between 1992 and 1994, these gaps are expected to grow. By 1994, the gaps are estimated to be $1,857 for a family of three and $5,254 for a family of four. The federal EIC does not fully compensate for the erosion in the purchasing power of the minimum wage since 1980, nor for the wage erosion in low-paying jobs described by Professor Blank.

Figure 4
Poverty Gap For Working Family of Four
With Two Children



The same is true of wages earned in conjunction with AFDC. A mother with two children and wages equal to 75 percent of the poverty line had $3,300 less to spend (including the EIC) in 1991 than she had in 1972, *even though the EIC did not exist in 1972*. If the EIC expansions had been phased in fully in 1991, such a family would still have $2,600 less in disposable income than in 1972.[8]

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[8] In this analysis, spendable or disposable income equals wages, AFDC, food stamps, and EIC benefits minus federal income and payroll taxes. The figures are for families with no child care expenses. For families with child care expenses, the loss in disposable income since 1972 is very similar. Committee on Ways and Means, *op. cit.*

Policy Options

Several policy changes could make work pay enough to lift a low-wage worker's family out of poverty. Restoring the purchasing power of the federal minimum wage to its average level in the 1960s and 1970s would help significantly, but would still leave a gap between wages and poverty for larger families.[9] States can raise their minimum wage above the federal level, as 17 did in the late 1980s, when the federal wage had languished at $3.35 an hour since 1981. Today, seven states have minimum wages above the federal level.

Changes also could be made in AFDC programs to allow a more gradual reduction in benefits until wages and benefits reached the poverty level, with a gradual transition to independence from benefits — although this does not seem likely in the foreseeable future. In addition, many economists are calling for broader policy changes, such as increases in public and private investment, to boost productivity growth and thereby reverse the decline in wages over the past two decades.

Among these options, state earned income credits are a specific, targeted approach to making work pay. As an addition to the federal credit, they can help close the gap between earnings and a living wage — at a very modest cost.

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[9] The minimum wage was last adjusted in April 1991, to $4.25 an hour.

III. The Federal Earned Income Credit

The federal earned income tax credit was established in 1975 to offset the adverse effects of Social Security and Medicare payroll taxes on working poor families and to strengthen work incentives.[10] Since its inception, the EIC has enjoyed strong bipartisan support and has been expanded several times.

Administered through the federal income tax system, the EIC is a *refundable* tax credit. If the amount of a family's credit exceeds its tax liability, the family receives a refund check from the government. For example, if a working family earns too little to owe federal income tax but qualifies for a $600 EIC, the IRS will send the family a check for $600. (A non-refundable tax credit only offsets income taxes. If a non-refundable credit exceeds the taxes owed, the additional credit amount is forfeited.)

Several features of the EIC make it attractive to policymakers across the political spectrum. It is popular because it is a work incentive, pro-family, and efficient.

The Earned Income Credit Is:

- A Work Incentive
- Pro-Family
- Efficient

The credit is "pro-work" because only parents who work can qualify for it. In addition, for families with very low earnings, the value *increases* as earnings rise. Welfare benefits, on the other hand, fall quite dramatically as earnings

[10] Payroll taxes consume 7.65 percent of the earnings of these families, with employers paying an equal amount. Many economists believe that the employer's share of the payroll tax effectively comes out of workers' paychecks as well — that is, that wages would be higher if employers didn't have to pay this tax.

rise. For tax year 1992, the credit rises about 17 cents for each additional dollar earned until earnings reach $7,520. By tax year 1994, when the 1990 EIC expansions will be phased in fully, the credit will rise between 23 cents and 25 cents for each additional dollar earned until earnings reach about $8,100.

The EIC is "pro-family" because only parents who live with and support children are eligible. Fathers who do not live with their children do not qualify. The credit also does not discriminate against two-parent families; two-parent and single-parent working families at the same income level receive the same benefit.

The credit is efficient because it is well targeted on low- and moderate-income working parents. The largest benefits go to working families with incomes between about $7,000 and $12,000. Benefits then phase down, reaching zero when income reaches slightly over $22,000 using in tax year 1992. Unlike the personal exemption, which helps all except those with very high incomes, or the standard deduction, which aids most of those who do not itemize deductions, the EIC targets a much smaller pool of taxpayers and thus has a much more modest cost.

The History of the EIC

One of the first calls for something like the earned income credit came in 1972 from Ronald Reagan, then the governor of California. The EIC was enacted in 1975, at the urging of Senate Finance Committee Chairman Russell Long, the credit's most important champion in the 1970s.

For a decade, the earned income credit attracted little attention. But by the mid-1980s, federal tax burdens on the working poor had risen sharply. The three features of the income tax code most important to low-income working families — the personal exemption, the standard deduction and the earned income credit — all had failed to keep pace with inflation. Working poor families with incomes far below the poverty line owed federal income tax. Their Social Security payroll taxes had risen as well. The combined income and payroll tax burden for a family of four at the poverty line increased more than fivefold between 1978 and 1984.

When President Reagan submitted his tax reform proposals to Congress in 1985, he called for a major reduction in the taxes on the working poor. Reagan declared: "The tax system should not be an additional burden on those who are struggling to escape from poverty; insofar as possible, those below the poverty line should be freed from taxation altogether." In addition to substantial increases in the personal exemption and standard deduction, Reagan proposed a major enlargement of the EIC. Congress concurred, and the Tax Reform Act of 1986 both expanded the EIC and indexed it for inflation.

Even after passage of the Tax Reform Act, however, large numbers of working families with children remained poor. By the late 1980s, liberal and conservative policymakers alike saw a need to reward low-paid work more adequately, reduce poverty among working families with children, and make work a more viable alternative to welfare. Their concerns were partially reflected in passage of the Family Support Act of 1988, which required states to establish education, employment, and training programs for AFDC recipients, while substantially increasing federal funding for such programs. These concerns also generated interest within both parties in further enlargement of the earned income credit.

Other developments strengthened this interest. As Congress and the White House began negotiating in 1990 on a large-scale deficit reduction package, it became clear that increases in gasoline, alcohol, and tobacco excise taxes would be included. Such taxes take a significantly larger share of income from poor families than those at higher income levels. Many policymakers saw EIC expansion as a way to help offset the impact of regressive tax increases on low-income working families.

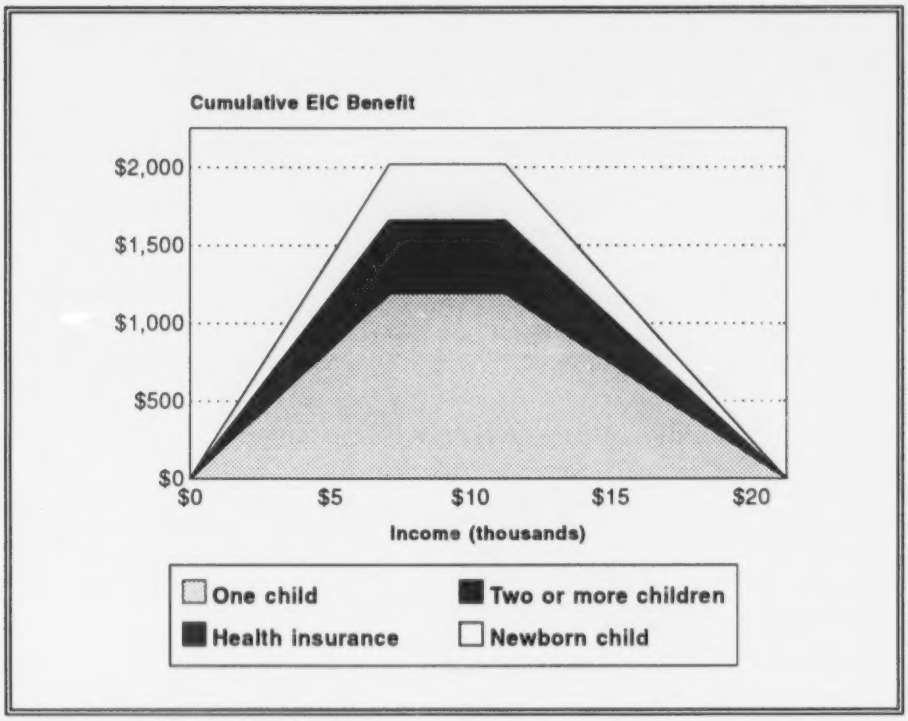
This led to inclusion of a major EIC expansion in the 1990 budget agreement. As a result, eligible families now receive a much larger credit. Eligible families with a child under age one receive a new, additional credit, as do families incurring costs for a health insurance policy that covers a child.

The 1990 EIC expansions are phased in over four years. After 1994, when the new EIC provisions are fully phased in, the credit will continue to be adjusted each year to keep pace with inflation.

How the EIC Works

In tax year 1992, families with children and incomes up to $22,370 are eligible for the EIC. The EIC now has three components: a basic credit, a young child supplement, and a health insurance credit. All eligible families receive a basic credit. EIC families with a child under one year of age are also eligible for the young child supplement. Those EIC families that pay part or all of the cost for premiums for a health insurance policy that covers a child can also receive the health insurance credit.

Figure 5
The EIC in Tax Year 1992



The basic credit amount is determined by a family's earnings and the number of children it has. In tax year 1992, the basic credit equals 17.6 percent of the first $7,520 of earnings for families with one child. A family with income of $7,520 thus qualifies for a credit of $1,324. This is the maximum *basic* credit for a family with one child. For families with two or more children, the credit is 18.4 percent of the first $7,520 of earnings, or a maximum of $1,384.

The credit remains at these maximum levels for families with earnings between $7,520 and $11,840. It then phases down slowly, declining about $13 for each $100 of income above $11,840.[11] When income reaches $22,370, the credit phases out entirely. Specific phase-out rates and ranges are shown in Tables II and III.

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[11] Over the first $7,520 of income, a family's basic EIC increases as *earnings* rise. For families with income between $11,840 and $22,370, the credit declines slowly as *adjusted gross income* rises. Thus, for families with very low earnings, the EIC amount is based solely on earnings. For moderate-income families, the EIC amount is based on earnings plus income from such sources as unemployment compensation, worker's compensation, and alimony. If income from these additional sources drives adjusted gross income above $22,370, the family is no longer eligible for EIC benefits.

Table II
Basic EIC Benefit Structure for
Families With One Child, 1991-94

Tax Year	Credit Percentage	Maximum Benefit	Phaseout Percentage	Phaseout Range
1991	16.7% of first $7,140	$1,192	11.93%	$11,250 to $21,250
1992	17.6% of first $7,520	1,324	12.57	11,840 to 22,370
1993	18.5% of first $7,790	1,441	13.21	12,270 to 23,180
1994	23% of first $8,070	1,856	16.43	12,710 to 24,010

Note: Dollar amounts for tax years after 1992 are based on the current inflation estimates of the Congressional Budget Office. Precise dollar amounts may vary when inflation estimates are revised.

Table III
Basic EIC Benefit Structure for
Families With Two or More Children, 1991-94

Tax Year	Credit Percentage	Maximum Benefit	Phaseout Percentage	Phaseout Range
1991	17.3% of first $7,140	$1,235	12.36%	$11,250 to $21,250
1992	18.4% of first $7,520	1,384	13.14	11,840 to 22,370
1993	19.5% of first $7,790	1,519	13.93	12,270 to 23,180
1994	25% of first $8,070	2,018	17.86	12,710 to 24,010

Note: Dollar amounts for tax years after 1992 are based on the current inflation estimates of the Congressional Budget Office. Precise dollar amounts may vary when inflation estimates are revised.

During tax years 1992 through 1994, the basic credit increases substantially. By tax year 1994, the maximum basic credit is estimated to be $1,856 for families with one child and $2,018 for families with two or more children.

For EIC families with a child under one year of age, the "young child supplement" equals five percent of the first $7,520 in earnings in tax year 1992. It, too, begins phasing down once family income surpasses $11,840 and phases out when income reaches $22,370. For tax year 1992, an eligible family can receive a supplemental EIC benefit of up to $376.

Table IV
Supplemental EIC for Families
With a Child Under One, 1991-94

Tax Year	Credit Percentage	Maximum Benefit	Phaseout Percentage	Phaseout Range
1991	5% of first $7,140	$357	3.57%	$11,250 to $21,250
1992	5% of first $7,520	376	3.51	11,840 to 22,370
1993	5% of first $7,790	390	3.54	12,270 to 23,180
1994	5% of first $8,070	404	3.56	12,710 to 24,010

Note: Dollar amounts for tax years after 1992 are based on the current inflation estimates of the Congressional Budget Office. Precise dollar amounts may vary when inflation estimates are revised.

Families that incur premium costs for a health insurance policy that covers a child — including families that make copayments for premium costs under an employer-sponsored health plan — are eligible for the EIC health insurance credit. This credit equals up to six percent of the first $7,520 in earnings, or up to $451, for tax year 1992. Like all other EIC components, the health insurance credit begins phasing down when income rises above $11,840 and phases out at an income level of $22,370. The health insurance credit may not exceed the premium costs the family paid during the year.

The EIC effectively operates as a wage supplement and lifts low-wage working families with children closer to, or in some cases above, the poverty line. By tax year 1994, the EIC will provide the equivalent of about a $1-an-hour wage supplement to parents who work full time year round at the minimum wage.

Table V
EIC Health Insurance Credit, 1991-91

Tax Year	Credit Percentage	Maximum Benefit	Phaseout Percentage	Phaseout Range
1991	6% of first $7,140	$428	4.285%	$11,250 to $21,240
1992	6% of first $7,520	451	4.208	11,840 to 22,370
1993	6% of first $7,790	467	4.248	12,270 to 23,180
1994	6% of first $8,070	484	4.266	12,710 to 24,010

Note: Dollar amounts for tax years after 1992 are based on the current inflation estimates of the Congressional Budget Office. Precise dollar amounts may vary when inflation estimates are revised.

The EIC is Efficient

Compared with the amount of tax relief provided by more long-standing and widely used tax code provisions, the credit provides substantial tax relief for relatively few dollars. In 1992, for example, the federal EIC (including supplements) will provide eligible families up to $2,211 at an estimated cost of $10.9 billion. In contrast, the personal exemption provided the typical family of four with $1,230 of relief in 1990 at a cost of $169 billion.[12]

The EIC costs less because it is targeted to a finite group — those families with low and moderate incomes that have dependent children. It is far more targeted, and thus more efficient, than the personal exemption for which all but very high-income taxpayers are eligible, or the standard deduction that is used by low- and middle-income taxpayers regardless of household status.

EIC Participation on the Rise

More and more low- and moderate-income taxpayers are filing for the earned income credit. From 1987 to 1990, participation in the program increased by 46

[12] This is the amount that personal exemptions reduced tax liability for four-person families in the 15 percent tax bracket.

percent. This was due, in part, to a significant increase in the income eligibility limits as a result of federal tax reform in 1986. Other contributing factors include outreach efforts that promote awareness of the credit and the beginning of the recession in 1990. Table VI shows 1990 participation by state.

Table VI
Federal EIC Participation by State, 1990

State	Total Federal Returns	Total Returns Claiming EIC	EIC Claims as Percent of Total Federal Returns
Alabama	1,711,765	319,441	18.7%
Alaska	313,610	16,908	5.4
Arizona	1,602,781	216,122	13.5
Arkansas	965,282	175,524	18.2
California	13,734,942	1,755,297	12.8
Colorado	1,564,022	147,929	9.5
Connecticut	1,658,349	77,810	4.7
Delaware	328,496	29,624	9.0
D.C.	318,036	44,782	14.1
Florida	6,141,001	762,327	12.4
Georgia	2,881,979	451,038	15.7
Hawaii	555,488	36,291	6.5
Idaho	427,628	52,881	12.4
Illinois	5,357,997	516,679	9.6
Indiana	2,525,554	251,523	10.0
Iowa	1,268,962	103,092	8.1
Kansas	1,103,989	101,547	9.2
Kentucky	1,515,983	208,868	13.8
Louisiana	1,688,430	333,570	19.8
Maine	566,064	53,094	9.4
Maryland	2,333,538	203,222	8.7
Massachusetts	2,900,054	169,378	5.8
Michigan	4,168,074	330,746	7.9
Minnesota	2,024,807	131,470	6.5
Mississippi	1,015,361	260,859	25.7
Missouri	2,287,618	258,600	11.3
Montana	355,448	41,943	11.8
Nebraska	732,497	67,543	9.2
Nevada	618,087	62,514	10.1
New Hampshire	539,812	34,400	6.4
New Jersey	3,864,727	304,558	7.9
New Mexico	660,692	118,089	17.9
New York	8,211,711	800,752	9.8
North Carolina	3,041,823	449,941	14.8
North Dakota	281,005	26,523	9.4
Ohio	5,086,743	442,844	8.7
Oklahoma	1,316,283	187,640	14.3
Oregon	1,305,875	124,271	9.5
Pennsylvania	5,531,879	449,544	8.1
Rhode Island	468,677	36,839	7.9
South Carolina	1,551,463	259,237	16.7
South Dakota	311,932	34,116	10.9
Tennessee	2,170,008	331,387	15.3
Texas	7,406,799	1,217,591	16.4
Utah	682,128	69,968	10.3
Vermont	266,699	21,798	8.2
Virginia	2,884,601	275,937	9.6
Washington	2,302,696	181,984	7.9
West Virginia	697,090	92,549	13.3
Wisconsin	2,258,467	162,259	7.2
Wyoming	205,492	20,796	10.1
U.S. Total	114,788,071	12,856,425	11.2%

Note: U.S. totals include tax returns from U.S. territories outside the 50 states and the District of Columbia.

IV. State Earned Income Credits

State earned income credits are a good policy option for states for the same reasons they are a good option at the federal level.

- As a *reward for work,* an earned income credit can help bring the wages of poor families up to or slightly above the poverty level. By doing this, an earned income credit can enhance state efforts to decrease reliance on welfare.

- As a *pro-family* policy, an earned income credit available to two-parent and single-parent families could encourage families to remain together. It rewards low-wage working parents who live with and care for their children.

- As *efficiently targeted* tax policy, a state earned income credit is less costly than other means of achieving similar goals.

Two additional advantages make earned income credits particularly appropriate state policy.

- Earned income credits can *prevent states from taxing families deeper into poverty.* Some 24 of the 42 states with income taxes still tax significant numbers of working poor families. This stands in contrast to the federal system, under which families with incomes below the poverty level generally have no income tax liability. A state earned income credit can raise the income at which poor families with children begin to owe tax, and so prevent the state from reducing their already meager wages.

- Earned income credits can *offset the effects of other regressive state and local taxes on the poor.* Most states rely on sales and excise taxes for funds. A refundable state earned income tax credit can offset the regressive effects of these taxes on working poor families with children.[13]

Creating a State EIC

Creating a state EIC is relatively simple. The states with EICs simply have conformed to the federal provisions. Using federal eligibility criteria to determine who can receive state EIC benefits, states express their EIC as a percentage of the federal EIC. For the family, the procedure is equally simple. To determine its state EIC benefit, the family need only write its federal benefit on its state return and then multiply the federal amount by the state EIC percentage.[14] This approach is also efficient.[15]

In recent years, the EIC has grown in popularity with state legislatures. The first state with an earned income credit was Rhode Island. Since 1987, Iowa, Maryland, Minnesota, Vermont, and Wisconsin also have adopted earned income credits. State credits generally receive support across the political spectrum, just as the federal EIC does.

There are four decisions to be made when considering a state EIC:

- whether to make the credit refundable;
- whether to adjust the EIC for family size;
- whether to conform to the total federal EIC or the basic federal EIC; and
- the percentage of the federal EIC at which the credit will be set.

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[13] In 1991, for example, Minnesota established a state earned income credit as an accompaniment to an increase in its sales tax rate.

[14] Five of the six states with EICs base their benefit on a percentage of the federal credit, including the young child supplement and the health insurance credit. Only Wisconsin bases its credit on the *basic* federal EIC.

[15] Families can receive federal EIC payments in advance, dispersed in equal portions throughout the year. This increases the take home pay of a family eligible for a $2,000 benefit by almost $77 per pay period. No state provides advance payments, however, because the payment would not be large enough to justify the administrative costs.

Refundable and Non-Refundable Credits

Of the six states with EICs, three — Minnesota, Vermont, and Wisconsin — have refundable credits. In these states, a family is sent a check for any amount by which its EIC exceeds income taxes owed.

For example, if a taxpayer owes $100 in state income taxes and is eligible for a refundable $200 earned income credit, the first $100 offsets the income tax liability and the state issues the family a check for the remaining $100. If the credit were non-refundable, the family's income tax liability would be eliminated, but the remaining $100 would be forfeited.

State Earned Income Credits

Refundable Credit	Non-Refundable Credit
Minnesota	Iowa
Vermont	Maryland
Wisconsin	Rhode Island

A refundable earned income credit can serve a wider variety of purposes than a non-refundable credit. Refundable EICs not only provide income tax relief but can provide relief from regressive sales and excise taxes. In addition, in states that already exempt most or many of the poor from income tax, refundable EICs supplement the income of poor families that work for most or all of the year.

The three states with refundable EICs have somewhat different credit structures. Vermont's EIC equals 28 percent of the federal EIC.[16] Minnesota's credit equals 10 percent of the federal. Working poor families do not owe state income tax in either state; in these states the EIC supplements wages for the working poor.

Wisconsin's refundable EIC is unique in that it is adjusted for family size. It equals five percent of the federal EIC for families with one child, 25 percent of the federal EIC for families with two children, and 75 percent for families with three or more children. The Wisconsin EIC both eliminates state income tax on most working poor families that would otherwise owe tax and provides a wage supplement for working families.

In all three states, the EIC also provides some income tax relief for working families with incomes modestly above the poverty line.

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[16] In Vermont, a household's income tax liability equals 28 percent of its federal income tax liability. The same percentage is used for the state EIC.

Non-refundable EICs can be an inexpensive way to target tax relief to low- and moderate-income working families and to absolve working poor families of income tax liabilities. They are considerably less expensive than refundable credits and are particularly well suited to states that have low income tax thresholds and that impose significant income tax burdens on the working poor. Non-refundable state EICs do not supplement wages or offset the regressive effects of other taxes.

Iowa, Maryland, and Rhode Island have non-refundable EICs. The Iowa credit is 6.5 percent of the federal credit and provides modest income tax relief for working poor families. Although the credit provides a maximum tax benefit of just $80, it raises the state income tax threshold for a family of four by $1,500.

Maryland's EIC is 50 percent of the federal credit and, when adopted in 1987, it eliminated income tax liabilities on many working poor families.

Maryland's EIC serves another important purpose as well. Since establishing its EIC, Maryland has adopted a "no-tax floor" — an income below which no income tax is owed. No-tax floors are an inexpensive way to absolve working poor families of income tax burdens. But no-tax floors can result in sharp increases in tax burdens for families whose incomes rise just slightly above the floor. In Maryland, the EIC helps to remedy this problem.

In Maryland, the no-tax floor is set at the poverty line. Without a state EIC, a family of four with income just one dollar above the poverty line would face a combined state and local income tax of $477 for 1992. The state EIC eliminates this liability and effectively raises the income tax threshold an additional $1,119. Hence, Maryland's EIC eases taxpayers into the state's tax system and avoids sudden jumps in income tax burdens for families with children. (See Table VII.)

The final state with a non-refundable EIC is Rhode Island. Rhode Island's EIC is a *de facto* credit; its existence is a function of the state's general income tax laws rather than a result of specific EIC legislation. Rhode Island's state income tax is 27.5 percent of federal income tax liability. In determining tax liability, the state uses the federal income tax owed *after* the federal earned income credit is subtracted. As a result, near-poor and moderate-income Rhode Island families benefit from a de facto state EIC equal to 27.5 percent of the federal credit. As in Vermont and Minnesota, working poor families are not affected because they do not owe state income tax.

Table VII
The Effect of the Maryland EIC on Two-Parent Families of Four
With Incomes At and Slightly Above the Poverty Line in 1992

Income	State Inc. Tax Without EIC	State EIC	State Inc. Tax After State EIC	Local Inc. Tax (50% of St. Tax)	Combined State and Local Inc. Tax
			Without State EIC		
$14,381*	$ 0	$ 0	$ 0	$ 0	$ 0
14,382	311	0	311	166	477
15,500	359	0	359	180	539
			With State EIC		
$14,381*	$ 0	$ 0	$ 0	$ 0	$ 0
14,382	311	311	0	0	0
15,500	359	355	4	2	6

*Projected poverty line for 1991 based on CBO inflation forecasts, January 1992. In Maryland, taxpayers with incomes below the poverty line owe no state income tax.

Family-Size Adjustments

The 1990 federal expansions added a family-size adjustment to the EIC, but the adjustment is very small. When the expansions are phased in fully in 1994, the maximum benefit for families with two or more children will exceed the benefit for a family with one child by $160. By contrast, the poverty line rises more than $2,000 for an additional child.

The federal EIC contains no additional adjustment for families with three or more children. Yet Census data show that 60 percent of all children in working poor families live in families with three or more children.

If a state does not adjust its credit for family size, its family-size differential will be tiny. For example, if a state credit equals 20 percent of the federal EIC, the maximum state EIC for a family with two or more children will exceed the credit for

families with one child by just $32. By contrast, in Wisconsin, the credit for a family with three or more children will, by fiscal year 1994, exceed the credit for a family with one child by more than $1,400.[17]

There are both advantages and disadvantages to a state EIC family-size adjustment such as the one Wisconsin uses. Setting a state EIC at a single, uniform percentage of the federal EIC, without family-size adjustments, is simple. It is also likely to be somewhat easier to estimate the cost of an EIC without a family-size adjustment. On the other hand, one of the chief flaws of the federal EIC is its lack of a more adequate family-size differential.

A family's needs and basic living expenses increase with its size. So does the poverty line. Welfare benefits rise somewhat with family size, as well. But wages do not. As a result, working families fall further and further below the poverty line as family size increases.

Establishing a family-size adjustment in a state EIC does not need to add to cost. There are more EIC families with one child than with three or more children. A state can set its EIC for families with one child at a lower percentage of the federal credit and its credit for families with three or more children at a higher percentage without affecting overall costs.

Including a family-size adjustment is most relevant when a state EIC is refundable and will be supplementing the wages of working poor families.

The Basic Credit vs. the Total Credit

Five of the states with EICs express their credits as a percentage of the total federal EIC, which includes the supplemental credits for a child under one year of age and for premiums for health insurance that covers a child. One state, Wisconsin, expresses its EIC as a percentage of the federal *basic* EIC. There are advantages and disadvantages to each approach.

When the federal EIC was expanded in 1990, many tax, health policy, and poverty experts questioned the wisdom of creating the two new supplemental credits. They urged that the money for the new credits be used instead to enlarge the basic credit further. The federal health insurance credit provides a maximum benefit of $428 per family, far below the cost of most family health insurance policies. The

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[17] Wisconsin initially adopted its family-size adjustment before the federal government established its small family-size differential in 1990. Wisconsin subsequently decided to retain its family-size adjustments.

credit is probably far too small to lead families lacking insurance to purchase it; the credit is likely to do little to improve access to health care among the uninsured. In fact, some analysts worry that the existence of the credit may encourage some employers to institute or increase co-payments for health insurance premiums, which could in turn reduce access to health care. Nor do most analysts believe there is a good reason for providing a somewhat higher EIC for families with a child under one. Proponents of this credit argued that it would encourage mothers with young children (in two-parent families) to say home rather than go to work, but the maximum credit amount is $357 — $6.86 per week — and is much too small to have such an effect.[18]

There is no strong policy reason for states to adopt these supplemental credits. States tying to the basic federal EIC will distribute benefits more evenly among low-income families with children. For any given level of state expenditures, less will go to families who fit the special circumstances of the supplemental credits, and more to all other low-income families.

The disadvantage of conforming to the basic benefit is administrative. To claim a state benefit that is a percentage of the basic federal benefit, families must transfer a number from the middle of the federal Schedule EIC calculation to the state tax form. This may be confusing. Families that have the IRS compute their federal credit may never know the amount of their basic federal EIC, and so would not be able to report that amount to the state. If a significant number of low-income families were deterred from claiming their state EIC because of this complexity, the advantage of spreading EIC benefits more fairly and more broadly would be canceled.

States can overcome this disadvantage by calculating the EIC for families who do not know the amount of their basic federal EIC when they file their state tax return. If a state will calculate the EIC for any taxpayer who attaches the federal Schedule EIC with the front page completed, as Minnesota does, there is no administrative problem in conforming to the basic federal EIC rather than to the total federal EIC.

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[18] The supplemental credits were enacted for primarily political reasons and may be repealed. The health insurance credit was adopted at the insistence of Senator Lloyd Bentsen, its author. Bentsen chairs the Senate Finance Committee. The young child supplement was initially rejected by both the Senate Finance Committee and the House Ways and Means Committee but was inserted into the final legislation at the last minute at the insistence of former White House Chief of Staff, John Sununu. Rep. Dan Rostenkowski, Chair of the House Ways and Means Committee, introduced legislation in late 1991 to repeal the two supplemental credits and plow the savings into the basic credit, which would be further enlarged.

State EICs: Particularly Beneficial in Rural States

EICs should be particularly attractive to rural states. Census data indicate that two-thirds of all poor rural families work, a significantly higher percentage than in urban areas. In addition, poverty rates among working families in rural areas increased significantly during the 1980s.

Since the rural poor are more likely to work than the urban poor, they are more likely to be eligible for an earned income credit. In 1987, some 64.7 percent of rural poor families had earnings, and nearly one-quarter (23.4 percent) had at least two workers. By contrast, 54.1 percent of poor families in metro areas had at least one worker, with 15.9 percent of them having two or more workers. Furthermore, by 1987, some 10 percent of rural working families were poor, an increase of nearly one-third from 1978.

This suggests the need for policies that reward work and enhance the wages of rural working poor families. A state EIC is an excellent way to do so.

The manner in which the EIC provides benefits is well suited to rural areas, as well. Barriers, such as lack of transportation, that might prevent rural residents from applying for public assistance do not prevent receipt of the EIC. Income tax forms and the special Schedule EIC may be received and submitted by mail. In addition, the private nature of the application process avoids any stigma that may be attached to public assistance.

The Presence of the Working Poor in Nonmetro Areas

	Nonmetro Areas	Metro Areas
Proportion of families that have at least one worker	64.7%	54.1%
Proportion of families that have two or more workers	23.4	15.9

Cost Consideration

Once the first three decisions are made — whether the credit will be refundable, whether it will be adjusted for family size, and whether it will conform to the basic or total federal credit — EIC costs will be determined by two further factors:

- the percentage of the federal EIC allowed as a state credit; and
- the percentage of families receiving the federal credit that will file for the state credit. This issue will be discussed later.

States have designed credits that range from 6.5 percent to 50 percent of the federal EIC. States can put their credit within cost limits by adjusting this percentage.

V. State EICs Improve Progressivity

EICs also contribute to a more equitable distribution of tax burdens and make state tax codes somewhat less regressive.

A tax system is *progressive* when taxpayers pay higher percentages of their incomes in taxes as their incomes rise. A tax system is *regressive* when lower- and middle-income taxpayers pay greater percentages of their incomes in taxes than upper-income taxpayers do. Virtually all state tax systems are regressive, primarily because of their heavy reliance on regressive tax sources.

The State Track Record in Recent Years

Since passage of the federal Tax Reform Act of 1986, some 36 of the 42 states with an income tax raised the income at which the tax begins to be owed, thereby eliminating income tax liability for some or all of the working poor.[19] These states raised their income tax thresholds for a family of four by an average of $4,956. (See Table VIII.)

In 1986, only three states set their income tax thresholds for a family of four at or above the poverty line. Now 18 states do.

These steps have lessened the regressivity of state codes, reducing disincentives to work and boosting the disposable income of low-income working families. In many of these same states, however, regressive sales and excise taxes were raised during the same period. Between 1985 and 1990, state sales taxes were

[19] For the purposes of this analysis, the District of Columbia is counted as a state. Connecticut's enactment of an income tax in 1991 brings the total to 42 states.

increased 22 times and state motor fuels taxes were raised 92 times.[20] Often, the regressive tax hikes more than canceled out the relief provided through reduced income tax burdens. A recent study by Citizens for Tax Justice indicates that the overall regressivity of state and local taxes increased between 1985 and 1990 despite the improvement in state income tax structures.[21]

This pattern continued in 1991. Some 34 states raised taxes. In the overwhelming majority of these states, the tax increases were regressive. Only two states, Connecticut and Rhode Island, raised taxes in a clearly progressive manner.[22]

Finally, despite the progress in reducing income tax burdens on the working poor, 24 states — three-fifths of all those with an income tax — continue to tax some working families with incomes below the poverty line. In these states, the income tax threshold for a family of four falls an average of $5,100 below the poverty line.

Refundable Tax Credits and State EICs

Refundable low-income tax credits, and particularly EICs, offer a well-targeted mechanism to moderate the regressivity of state tax codes and reduce income tax liabilities on working poor families. In 1991, six states that raised regressive taxes accompanied these tax hikes with the establishment or enlargement of a targeted low-income tax relief provision. One state, Minnesota, established an earned income credit along with a sales tax hike.

When the federal EIC was enacted in 1975, it was designed in part to offset the regressive impact of Social Security and Medicare payroll taxes on working poor families. When the EIC was expanded substantially in 1990, it was partly to offset the regressive impact on low-income working families of higher federal gasoline, alcohol, and tobacco taxes.

An earned income credit can perform a similar function for a state. An EIC can be a useful tool for policymakers looking to offset some of the regressivity of state and local taxes at moderate cost.

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[20] Robert S. McIntyre, et al, *A Far Cry From Fair: CTJ's Guide to State Tax Reform* (Washington, D.C.: Citizens for Tax Justice and the Institute on Taxation and Economic Policy, April 1991), pp. 6 and 7.

[21] *Ibid.*, p. 18. The data in this study reflects tax burdens for families of four.

[22] Isaac Shapiro, Steven D. Gold, Mark Sheft, Julie Strawn, Laura Summer, and Robert Greenstein, *The States and the Poor: How Budget Decisions in 1991 Affected Low Income People*, Center on Budget and Policy Priorities and Center for the Study of the States, December 1991.

Decreased Progressivity at Federal Level Contributes to Widening Gaps Between Rich and Poor

The federal tax code, as well, has become somewhat less progressive in recent years. A study by the Congressional Budget Office shows that for most households (the bottom four-fifths of the income distribution), the percentage of income paid in federal taxes was about the same in 1989 as in 1977. Among the wealthiest one percent of the population, however, the percentage of income paid in federal taxes fell one-fourth. Even after taking into account the upper-income tax increases enacted in 1990, the percentage of income paid in federal taxes by the wealthiest one-percent of the population will still be nearly one-fifth lower in 1992 than in 1977.[23]

CBO found that the reduced progressivity of the federal tax code contributed to the growing income disparities between rich and poor. Using data from the Census Bureau and the IRS, CBO found that the average *before*-tax income of the poorest fifth of the population fell nine percent between 1977 and 1989, after adjustment for inflation. The before-tax income of the middle-fifth of the population edged up four percent. Meanwhile, the before-tax income of the top fifth rose 29 percent; and for the richest one percent of the population, it climbed 77 percent.

When *after*-tax income was examined, CBO found that the bottom fifth still fell nine percent, while the middle fifth still registered about a four percent gain. But the average after-tax income of the top one percent of the population increased a stunning 102 percent. One-quarter of the large increase during this period in the after-tax income of the wealthiest Americans appears due to changes in federal tax policies.

Household Income Category	Change in Before-Tax Income 1977-1989	Change in After-Tax Income 1977-1989
Lowest Fifth	- 8.8%	- 9.1%
Middle Fifth	+ 4.2	+ 4.5
Top Fifth	+29.0	+ 32.0
Richest One Percent	+77.1	+101.7

The trend toward widening disparities in the distribution of after-tax income is particularly sharp among families with children. The CBO data show that from 1977 to 1989, the average after-tax income of the poorest fifth of families with children plunged 19 percent, after adjustment for inflation. The after-tax income of the next-to-the-bottom fifth of families with children fell 8.5 percent. Yet the average after-tax income of the wealthiest fifth of families with children rose 27.2 percent. Data on the top one percent of families with children were not available.

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[23] The CBO data for 1977 and 1989 and CBO projections for 1992 are published in House Committee on Ways and Means, *Background Material on Family Income and Benefit Changes*, December 19, 1991, pp. 61-81. CBO used 1977 as its initial year because it preceded significant tax changes in Social Security and income taxes enacted in 1977 and 1978. 1989 is the latest year for which these data are available. In placing households in different income categories, CBO adjusted incomes to reflect household size.

Table VIII
State Income Tax Thresholds for
Two-Parent Families of Four in 1986 and 1991

State (Ranked According to 1991 Threshold)	1986 Tax Threshold	1991 Tax Threshold	Increase in Threshold from 1986 to 1991	Threshold Above/(Below) Poverty Line
1. Illinois	$4,000	$4,000	$0	(9,921)
2. Indiana	4,000	4,000	0	(9,921)
3. Alabama	4,500	4,500	0	(9,421)
4. Kentucky	4,300	5,000	700	(8,921)
5. New Jersey	4,000	5,000	1,000	(8,921)
6. Hawaii	5,300	6,100	800	(7,821)
7. Montana	6,240	6,600	360	(7,321)
8. West Virginia	3,600	8,000	4,400	(5,921)
9. Virginia	3,700	8,200	4,500	(5,721)
10. Michigan	6,000	8,400	2,400	(5,521)
11. Delaware	5,600	8,600	3,000	(5,321)
12. Missouri	6,900	8,900	2,000	(5,021)
13. Georgia	6,100	9,000	2,900	(4,921)
13. Iowa	5,000	9,000	4,000	(4,921)
15. Oklahoma	5,830	10,000	4,170	(3,921)
16. Oregon	6,900	10,100	3,200	(3,821)
17. Ohio	9,900	10,500	600	(3,421)
18. Arkansas	5,000	10,700	5,700	(3,221)
19. Louisiana	11,000	11,000	0	(2,921)
20. Massachusetts	6,400	12,000	5,600	(1,921)
21. Utah	4,300	12,200	7,900	(1,721)
22. Pennsylvania	5,700	13,000	7,300	(921)
22. Kansas	6,000	13,000	7,000	(921)
24. Wisconsin	9,200	13,900	4,700	(21)
25. Maine	6,200	14,100	7,900	179
25. New York	10,600	14,100	3,500	179
27. Colorado	6,200	14,300	8,100	379
27. D.C.	4,000	14,300	10,300	379
27. Idaho	8,000	14,300	6,300	379
27. Nebraska	8,000	14,300	6,300	379
27. New Mexico	12,000	14,300	2,300	379
27. North Carolina	4,300	14,300	10,000	379
27. North Dakota	8,000	14,300	6,300	379
27. South Carolina	10,300	14,300	4,000	379
35. Arizona	8,400	15,000	6,600	1,079
36. Maryland	5,830	15,500	9,670	1,579
36. Minnesota	9,300	15,500	6,200	1,579
38. Mississippi	15,900	15,900	0	1,979
39. Rhode Island	9,600	17,400	7,800	3,479
39. Vermont	8,000	17,400	9,400	3,479
41. California	14,300	21,000	6,700	7,079
42. Connecticut	N/A	24,000	N/A	10,079

Notes: The 1991 poverty line for a four-person family was $13,921 as projected by the Congressional Budget Office in January 1992. The thresholds include state earned income credits, personal credits in states that use them instead of personal exemptions, and special credits used by some states (e.g., Kentucky, New York, Pennsylvania, and Washington, D.C.) to reduce the income tax burdens on low-income wage earners. Other credits — such as property tax credits, sales tax credits, and dependent care credits — are not taken into account.

VI. The Need for Outreach

One advantage of the earned income credit is its high participation rate. Definitive data is not available, but estimates suggest that some 80 to 90 percent of eligible families are receiving the federal EIC.

State EICs also are likely to have high participation rates. Nevertheless, significant outreach needs to accompany state EICs for two reasons. First, there are still eligible families that do not receive the federal EIC, and this number could rise significantly as a result of new complexities in the federal EIC filing process. Second, some families may elect to have the Internal Revenue Service compute their federal EIC for them, and thus may have no federal EIC amount to enter on their state income tax return. States can take steps to address both of these problems.

Eligible Families Who Miss Out on the Federal EIC

Filing for the federal credit is a prerequisite to filing for a state credit. Yet many eligible working poor families may miss out on both the federal and state credits for one of two reasons: they fail to file a federal income tax return, or they fail to include Schedule EIC along with the return.

Some low-income working families have incomes so low that they are not required to file a federal income tax return. If they do not file a return they forfeit the benefits they have earned, so outreach must encourage all low-income workers to file a federal return.

Beginning in tax year 1991, there is an additional filing requirement. Low-income working families must file the new "Schedule EIC" along with their tax return in order to receive their federal credit. Some eligible families may allow this

complication to deter them from receiving their credit, so outreach efforts must also stress the importance of completing and including the Schedule EIC with the tax return.[24]

In states with an EIC, outreach efforts become doubly important because failure to file for the federal EIC precludes an eligible family from receiving the state EIC. Hence, outreach aimed at encouraging participation in a state EIC should encourage participation in the federal program, as well.

Since 1989, the Center on Budget and Policy Priorities has coordinated a national EIC outreach campaign involving thousands of state and local agencies, social service providers, charities, community groups, advocacy organizations, businesses, and labor unions. Starting in 1991, the Internal Revenue Service has substantially expanded its own EIC outreach. The Center and IRS make available a variety of materials, including camera-ready bilingual posters, flyers and envelope stuffers, a guide to successful outreach strategies, fact sheets, and sample PSA scripts.

IRS data indicate these efforts have been effective. For example, between tax year 1988 and tax year 1989, the number of families *eligible* for the federal EIC did not increase, and tax experts predicted a change of less than one percent in the number of families getting the EIC. Yet the number of families actually receiving the credit rose 770,000, or seven percent.

Such outreach efforts should prove similarly successful in promoting state EICs. States, social service providers, local governments, and advocacy, community-based, and neighborhood groups can piggyback on efforts used to promote the federal EIC in publicizing state EICs. For example, in Milwaukee the Congress for a Working America and the city are promoting use of both the federal and state EIC.

The targeting of state EIC outreach activities should be influenced somewhat by whether the credit is refundable. With *non*-refundable credits, outreach should focus on families with incomes above the state income tax threshold. Since families with lower incomes do not owe state income tax, they receive no benefit from a non-refundable EIC. Efforts should aim to increase awareness of the credit and the need to fill out the appropriate section of the state income tax return to apply. Outreach promoting refundable credits, on the other hand, should also place major emphasis on reaching working families with incomes too low to owe state income tax.

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[24] For tax year 1991, the IRS will in some cases award the *basic credit* to families that appear eligible whether or not the new Schedule EIC accompanies the return. In those cases, the IRS will also ask for further information to determine whether the family might also be eligible for the supplemental young child and health insurance credits. In other cases, the IRS will not issue the benefit, but it will notify taxpayers who appear eligible but did not submit the Schedule EIC of their potential eligibility. As of this writing, it is unclear whether IRS will continue these policies in tax years after 1991.

EIC Outreach Strategies

A variety of successful EIC outreach strategies have been conducted at state and local levels. Many of these strategies are designed to reach low-income working families through other benefit or service programs, stores where they shop, businesses where they work, or the media.

Many state and local EIC campaigns also seek to reach low-income working parents with EIC information through day care centers, churches and religious organizations, community groups, and labor unions. Many such groups routinely come in contact with eligible families. Such organizations can also use outreach strategies such as targeting mailings and placing EIC flyers and posters at gathering places like libraries, laundromats, stores, and check cashing agencies.

Many states send notices about the EIC to past and present beneficiaries of various assistance programs, including AFDC, food stamps, Medicaid, and unemployment insurance. Many of these families may have had some earned income during the previous year.

Training volunteers at taxpayer assistance centers is another effective way to promote the EIC. Many low- and moderate-income taxpayers depend on such services to file their federal and state returns. If volunteers at these centers help families fill out the appropriate sections of their tax returns, nearly all eligible taxpayers using these centers should receive their EIC benefits.

States and cities can also target their own EIC-eligible employees. Each winter, several cities and states notify all employees — or all employees below a certain grade level — about the EIC.

Media promotion techniques include press conferences and press releases that provide basic information on the EIC, and public service announcements for radio or television. In areas of ethnic diversity, multilingual materials can be especially useful.

Finally, some areas have a toll-free EIC hotline number during the tax-filing season.

Families Receiving the Federal EIC Who Fail to Get Their State EIC

A second problem area involves families that receive the federal EIC but fail to obtain their state EIC. The best information on the extent of this problem comes from Wisconsin and Vermont. In both states, data show 83 percent of the families receiving the federal EIC also receiving their state credits. Thus, about one-fifth of those receiving the federal credit seem to have missed out on the state credit.

In Maryland, 68 percent of families receiving their federal credit also receive their state credit. Maryland figures are less useful, however, because its EIC is non-

refundable. For families whose state income tax liability is zero, claiming the state EIC serves no purpose.

Why do some families receiving the federal credit fail to obtain their state credit? The best answer appears to be that some families have IRS compute their federal credit; as a result, they do not know the amount of their federal EIC when they file their state income tax return.

Now that filing for the federal credit has become more complex and the computations more involved, the number of families electing to have the IRS compute their federal EIC is expected to rise. This means the proportion of eligible families failing to receive state EIC benefits could increase significantly.

States can take two steps to deal with this problem:

- State revenue agencies can compute the basic federal EIC for families that asked IRS to figure their credit. States can ask these families to enclose a copy of their federal Schedule EIC with their state tax return. In most cases, computing the federal EIC will be straightforward. The state agency can then determine a family's state benefit with one additional computation: applying the state credit percentage.[25] Where state revenue agencies can perform this task, it is the preferred route.[26]

- An alternative is for states to use the IRS tapes they receive later to identify families that received a federal EIC but failed to get the state EIC. The state can readily compute the state benefits for these families and send them their EIC. Under this procedure, a family may not receive its state EIC payment until one or more years after the year in which the payment was due. Nevertheless, using this procedure is much better than not taking any action.

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[25] EIC states treat part-year residents differently. In Iowa and Maryland, any family eligible for the federal EIC is also eligible for a full state EIC regardless of whether the family lived in the state for the full year or not. Vermont bases the size of its credit on the number of months a taxpayer lives in the state. A taxpayer living in the state for half the year receives half the normal state EIC benefit. [Federal EIC X (.28) X (.50).] Minnesota bases its credit amount on the percentage of income earned while living in the state. So if a Minnesota family earned 30 percent of its annual income in the state, it would be entitled to 30 percent of the normal state EIC amount. [Federal EIC X (.10) X (.30).] In Wisconsin, you must live in the state for the full year to be eligible for the state credit.

[26] Of the states with EICs, only Minnesota will flag potential recipients and compute their state credit for them. To receive this service, however, the taxpayer must submit a federal Schedule EIC with the state return. If the first page of the Schedule EIC is filled out, the revenue department will calculate both the federal and state EIC amounts.

If a state follows *neither* of these approaches — and limits its EIC to those families claiming it on their state return — a substantial number of eligible families will miss the benefits they have earned. Nevertheless, if administrative difficulties preclude adopting either procedure, this should *not* rule out establishing an EIC. Even without one of these procedures, participation in a state EIC is likely to be higher than participation in most other means-tested assistance programs, including other state refundable tax credit programs.[27]

[27] Other state refundable tax credit programs typically do not have a federal counterpart, and so do not benefit from the type of publicity and outreach that surrounds the federal EIC.

VII. Two Case Studies

One factor making a state earned income credit attractive is its ability to generate support from policymakers across the political spectrum. An examination of how earned income credits came to be adopted in Wisconsin and Maryland illustrates the broad range of support that EICs can generate.

Wisconsin: Forging a Liberal-Conservative Alliance

Enacted in 1989, the Wisconsin earned income credit was the first EIC, either federal or state, to be adjusted for the number of children in the family. The credit equals five percent of the federal credit for families with one child, 25 percent of the federal credit for families with two children, and 75 percent of the federal credit for families with three or more children.

Sponsors of the Wisconsin credit were striving to come close to the goal of "making work pay." That is, they sought to make as much progress as possible toward enabling full-time, year-round minimum wage employment — when combined with both federal and state EICs — to lift a family out of poverty. Because the gap between minimum wage earnings and the poverty line increases with the number of children in a family, Wisconsin policymakers set the state EIC at higher percentages of the federal credit as family size increased.

The Wisconsin EIC was conceived by a bipartisan coalition primarily composed of women legislators. This coalition was led by Democratic Representative Rebecca Young and Republican Representative Margaret Lewis, the chair and ranking minority member of the Committee on Children and Human Services. Republican Representative Susan Vergeront, who chairs the Governor's Women's Council, was also key as were Tom Loftus, the Democratic Speaker of the House, and David

Reimer, Milwaukee's Director of Administration. Each of these coalition members played a major role in helping secure support for the state EIC concept.[28]

The "making work pay" concept held together the ideologically diverse pro-EIC forces. Conservatives were looking for an alternative to raising the minimum wage to address the income problems facing low-wage working families. Moderates were interested in encouraging welfare families to work and were looking for economic incentives for low-paid employment. Liberals were particularly attracted by the EIC's ability to lift working poor families closer to or above the poverty line.

Among proponents, it was universally agreed that the credit must be refundable if its objectives were to be met. All recognized that a non-refundable credit would not help most working poor families, since most had no state income tax liability. Liberals also saw refundability as necessary to achieve a more substantial improvement in the progressivity of the state income tax.

The proponents initially encountered some modest opposition to refundability. The Department of Revenue was concerned about constitutionality. There was also concern about whether the state could afford refundability. Conservative opposition developed among manufacturers and some conservatives who felt the income tax should be used only to collect taxes and that a refundable state EIC was nothing more than another spending program that transferred income to low- and moderate-income households.

The coalition took a number of steps to overcome this opposition. Republican members sold the EIC to conservatives as an alternative to raising the state's minimum wage. For conservatives opposed to a large minimum wage increase, a state EIC represented a viable alternative. In addition, Republican U.S. Representatives Thomas Petri of Wisconsin and Nancy Johnson of Connecticut

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[28] Wisconsin also had an EIC from 1983 to 1985, although this EIC was non-refundable. The idea for a state EIC grew out of Democratic House Speaker Tom Loftus' service on a welfare commission in the late 1970s. The commission, staffed by University of Wisconsin faculty, developed proposals for non-welfare approaches to reduce poverty. One of its recommendations was to establish a refundable state EIC. A bill to establish a refundable EIC passed the legislature in 1979 but was vetoed by the governor. A bill creating a non-refundable EIC was enacted in 1983.

The non-refundable credit was designed solely to reduce or eliminate income tax burdens on working poor families. In 1985, the legislature eliminated income tax burdens on most working poor families. This lessened the need for a non-refundable EIC and the credit was repealed.

Since 1985, however, Wisconsin's income tax threshold has not risen with inflation. On the other hand, the poverty line is adjusted upward for inflation annually. As a result, many working poor families that had been removed from the state's income tax rolls eased back onto them. The 1989 state EIC pushed the state income tax threshold back above the poverty line for Wisconsin's working poor families.

praised the EIC at a state Republican Party convention. Petri also spoke to the advantages of adjusting the credit for family size.[29]

These efforts resulted in broad-based Republican support for the proposed credit, which was instrumental in securing the backing of the Republican governor. The Republican embrace of the EIC eventually became so strong that at times conservatives had to downplay their enthusiasm so that liberals would not be scared away.

Democrats used some similar arguments in promoting the credit. The EIC was sold as tax policy that would promote work over welfare and help people help themselves. It was also promoted as an economical and administratively efficient way of providing assistance to working families and children in need.

The Democratic effort was buttressed by strong interest from organized labor and the city of Milwaukee. David Newby, the Secretary-Treasurer of the state's AFL-CIO, lobbied vigorously for the EIC, as did David Reimer, Milwaukee's Director of Administration. Reimer's contribution was particularly significant; he focused the attention of area legislators on the additional spending power an earned income credit would bring into the city's economy.

Maryland: Making of a Non-Refundable State Earned Income Credit

Maryland's EIC was established in 1987 as part of legislation conforming the state income tax code to the federal Tax Reform Act. The EIC was proposed by the incoming governor; nevertheless, its path through the legislature was not entirely smooth.

The Maryland EIC's trek through the legislative process began prior to Governor William Donald Schaefer's inauguration in 1987. The governor-elect's transition team solicited program options from various executive departments. A legislative analyst in the Department of Human Resources suggested a state earned income tax credit because it could provide significant tax relief for the working poor at a relatively modest cost. The Maryland Catholic Conference also strongly urged creation of a state earned income credit.

At the time the governor took office, Maryland imposed substantial state and local income tax burdens on the working poor. The projected state and local income tax liability for a two-parent family of four with income at the poverty line exceeded $450 for tax year 1988.

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[29] During the 1989 congressional session, Petri was the leading Republican proponent of enhancing the federal earned income credit and adjusting it by family size.

Broad Support for State EIC Leads to Extensive Outreach

While Wisconsin stands out for having the largest EIC and the sole state EIC adjusted for family size, it also warrants recognition for the extensive outreach activities it undertakes to promote the credit. A broad base of support when the state EIC was enacted has made it easier to mount outreach efforts.

For example, each winter the state Public Service Commission encloses an EIC notice with utility bills. The Department of Health and Social Services sends an annual mailing about the credit to AFDC and food stamp recipients. The Department of Revenue has developed EIC pamphlets that are distributed by state legislators and made available at libraries. The Revenue Department also attempts to place articles about the credit in newspapers. In addition, the state prints information about the state EIC on the back of lottery tickets.

There are a number of locally based public information efforts, as well. In Dane County, the City of Madison, the county, the state, and local utility companies work together to advertise the credit. The Dane County Community Action Agency also promotes the credit.

Perhaps the most notable local effort is a public-private partnership in Milwaukee involving the city, the non-profit Congress for a Working America, and the business-oriented Greater Milwaukee Committee. This effort is spearheaded by Congress for a Working America and promotes both the state and federal EICs. These organizations develop public service announcements about the credit, operate an "EIC hotline," prepare and disseminate multilingual educational materials, and promote outreach by labor unions, religious denominations, and other community-based organizations.

The governor's tax proposal contained several provisions designed to relieve the high income tax burdens on the working poor. It raised the standard deduction and established minimum standard deduction levels for various taxpayer categories.[30] It also established a non-refundable state earned income tax credit at 50 percent of the federal EIC. A 50 percent earned income credit was needed, in addition to the other proposed changes, to eliminate state income tax liability on families of four or fewer people with incomes at or below the poverty line.

The Maryland Catholic Conference, Associated Catholic Charities, the Maryland Alliance for the Poor, and the Department of Human Resources organized

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[30] Prior to 1987, Maryland's standard deduction was 13 percent of adjusted gross income. The maximum standard deduction in the state was $1,500 for single taxpayers and for taxpayers filing as heads of households and $3,000 for married couples filing jointly. The Governor's proposal sought to increase the standard deduction in several ways. First, the rate of the standard deduction would be increased from 13 percent to 15 percent of AGI. Second, the maximum standard deduction levels would increase to $2,000 and $4,000 respectively. In addition, minimum standard deduction levels would be set at $1,000 for single taxpayers and heads of households and $2,000 for married couples filing jointly.

a major effort to promote the low-income aspects of the governor's package. They placed particular emphasis on the EIC.

The lobbying coalition, except for the Department of Human Resources, also proposed a modification in the governor's proposal. The coalition urged that the proposed state EIC be applied against both state *and local* income tax liabilities borne by working poor families. (The governor's proposal would have subtracted the EIC only from state income tax. That would have left many poor families with substantial local income tax burdens, even if some of their state EIC remained unused after their state income taxes had been eliminated.[31])

The Legislative Black Caucus sponsored the proposal applying the state EIC to both state and local income tax liabilities. The Women's Caucus sponsored a separate change setting the standard deduction for heads-of-household at the same level as the standard deduction for married couples. Both caucuses agreed to support the low-income tax relief provisions in the governor's package with these two modifications.

The Maryland House approved the governor's low-income tax proposals with the two modifications. But, the Senate was more resistant. That body's tax writing committee developed its own proposal for conforming to federal tax reform that did not include a state earned income credit. In conference, however, the Senate accepted the House EIC provisions.

One aspect of the legislative developments in Maryland that stands out is the role played by the Black Caucus and the Women's Caucus. The combination of Black Caucus and Women's Caucus members on the Ways and Means Committee was sufficient to ensure that the governor's EIC proposal was not only approved but broadened so that the credit could offset local as well as state income tax burdens. Similarly, the presence of both Black Caucus and Women's Caucus members on the conference committee helped ensure approval of the EIC, along with the accompanying provisions that EIC supporters sought.

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[31] In all but one of Maryland's 24 local jurisdictions, the local income tax is 50 percent of the state income tax.

Appendix

State EICs are expressed as a proportion of the federal EIC, so federal EIC statistics are the starting point for calculating the cost of a state EIC.[32] The necessary federal statistics on recipients and costs by state are not current, however; they are published with a two- to three-year lag. In spring 1992, for example, the latest statistics available were for tax year 1989. This means that the expansion in the federal EIC benefits and establishment of the supplemental young child and health insurance credits — enacted in 1990 to phase in between 1991 and 1994 — will not be reflected in the statistics until late 1993. The lag makes calculating the cost of a state EIC an uncertain process. This appendix suggests some ways these problems may be circumvented.

There are several issues to consider in estimating the cost of a state EIC.

First, the cost estimate will depend on the portion of the federal credit to which the state conforms. Of the states that grant EICs, Wisconsin ties its credit to the *basic* federal credit only. A state seeking to follow Wisconsin's example will have costs that generally correspond to available, historical federal data. All other states currently granting the credit include the new young child and health insurance supplemental credits. States seeking to tie to the full, expanded federal credit will have to adjust their cost estimates accordingly.

Second, the state cost will be affected by the proportion of families receiving the federal EIC that are not likely to receive the state EIC. If a state with a refundable EIC does not make any efforts to help its taxpayers claim this credit, it may be estimated that 80 percent of those in the state receiving the federal EIC will

[32] An IRS quarterly publication, the *Statistics of Income Bulletin*, contains information on the number of federal EIC recipients and the amount of benefits paid in each state.

be likely also to claim the state EIC. This estimate is based on the experiences of Wisconsin and Vermont.[33] A state's participation would approach the federal participation level if it either calculates the state EIC for people who don't know their federal EIC amount (as Minnesota does) or uses the federal tapes to identify EIC-eligible families.

In addition to estimating the relationship between federal and state participation levels, states should be aware that future federal participation levels may be somewhat different from past levels. No data are yet available on whether the new federal EIC filing procedures, including the requirement to attach a separate EIC schedule to income tax returns, will significantly affect the number of families receiving the EIC.

States estimating the cost of an EIC may want to adjust historical data for economic conditions. Adverse conditions in 1991 and 1992 may temporarily increase the number of families qualifying for the EIC. During a recession, many families whose incomes are normally high enough to make them ineligible are either unemployed for part of the year or have their work hours reduced. These families could become eligible for the EIC during the downturn.

Finally, states contemplating enacting a *non-refundable* EIC should be aware that they cannot estimate their costs from federal data alone, because the cost of the non-refundable portion of the credit depends on the income level at which families begin to pay state income taxes. States for which this tax-paying threshold is different from the federal threshold must use a combination of federal and state statistics to develop cost estimates.

Estimating the Cost of a Refundable EIC

States that choose to set their EICs as a percentage of the basic federal credit, as Wisconsin has done, could follow the following cost estimating procedure.

First, determine the percent of the maximum federal EIC benefit that the *average* federal EIC benefit in a particular state represents for tax year 1989, the latest

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[33] This may yield an overestimate. Studies in Vermont and Wisconsin show 83 percent of the families receiving the federal EIC also receiving the state EIC. These studies reflect tax year 1989 in Vermont and tax year 1990 in Wisconsin. Introduction of the Schedule EIC beginning in tax year 1991 may result in a large percentage of EIC filers having the IRS complete their credits for them. These families would not know the amount of their federal EIC to transfer to their state tax form.

year for which these data are available.[34] Assume that the *average* federal EIC benefit in the state would remain at the same percentage of the *maximum* federal benefit over time.

Next, apply this percentage to the projected maximum federal EIC benefit for the year for which a cost estimate is desired. This should provide a reasonable estimate of the projected average federal EIC benefit in the state for the year in question.

Third, apply the state EIC percentage to the projected average federal EIC benefit for the state. This will provide an estimate of the average state EIC benefit.

Fourth, multiply the number of federal EIC recipients in the state by 80 percent to reflect the proportion of federal EIC recipients expected also to receive the state EIC. This will yield an estimate of the number of state EIC recipients.

And fifth, multiply the estimate of the average state EIC benefit by the estimated number of state EIC recipients to yield an estimated state EIC cost.

An example may help illustrate these steps.

1. In 1989, the maximum federal EIC benefit was $910. Assume that the average EIC benefit that year was $550 in a given state. Thus, the average credit for EIC recipients in the state would be approximately 60 percent of the maximum credit.

2. For tax year 1991, the maximum basic federal EIC benefit will be $1,217.[35] Multiplying this figure by 60 percent yields an estimated average federal EIC benefit of $730 for the state in question.

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[34] State-by-state data on EIC benefit amounts for tax year 1990, the last tax year before the federal EIC expansions took effect, will not be available until mid-1992. The maximum federal EIC benefits for 1989 and 1990 were $910 and $953, respectively.

[35] Census data from 1987 show that an estimated 43 percent of working families with children that had incomes below $17,800 had one child, while 57 percent of such families had two or more children. The $17,800 income level was the upper income limit for federal EIC eligibility in 1987. It is expected that similar family size ratios hold today for working families with children because the income eligibility parameters for the EIC have been automatically adjusted for inflation each year since 1987.

For tax year 1991, the maximum basic federal EIC benefit is $1,192 for families with one child and $1,235 for families with two or more children. Assuming constant family size ratios since 1987 for families with one child and for those with two or more children, the weighted average maximum benefit for 1992 should be $1,217.

3. Assuming that the state EIC is to be 20 percent of the basic federal credit, multiply $730 (from step 2) by 20 percent. This will yield a projected average state EIC benefit. ($730 X (.20) = $146)

4. Further assume that there are 250,000 federal EIC recipients in the state. Multiplying the number of federal recipients by 80 percent (.80) would yield an estimate of probable state EIC recipients. (250,000 X (.80) = 200,000).[36]

5. Multiply the projected average state EIC benefit ($146) by the projected number of state EIC recipients (200,000). The product is the approximate cost of a state EIC in the given state. (200,000 X $146 = $29.2 million)

If a state plans to calculate the federal and/or state EIC benefits for families that have asked the IRS to compute their federal EIC, then the estimated number of state EIC recipients *should not* be multiplied by 80 percent as suggested in step four. Under this circumstance, the state participation estimate should be nearly equal to the federal participation.

If a state does not intend to calculate the EIC benefit, but plans instead to use IRS tapes to identify, contact, and provide credit for eligible families that fail to claim a state credit, the initial cost estimate should be based on 80 percent participation. The close to 100 percent participation would not be reached until IRS tapes for the tax year become available and are processed — a lag of one to two years.[37]

Tying into the Full Federal EIC

States choosing to tie their state EICs to a percentage of the fully expanded federal EIC have to add an additional calculation because the cost of the supplemental benefits — the young child and health insurance credits — are not reflected in the 1989 or 1990 IRS data. The Congressional Joint Committee on Taxation has estimated that the supplemental benefits will add 13.5 percent to the

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[36] The 80 percent participation estimate is based on 1989 Wisconsin and 1990 Vermont experiences.

[37] Using 100 percent of federal participation for either of these methods of assisting families to claim their EIC benefit is likely to produce some overestimate of costs. Even if the state will compute EIC benefits, not all families will attach their federal Schedule EIC to their state tax return. If a state uses the IRS tape, some families identified as eligible will not receive a notification because they have moved out of state. There is no data, however, on the size of adjustment to make for these factors.

cost of the basic EIC benefits in tax year 1992.[38] The additional cost of the supplemental benefits in the state EIC may be assumed to parallel the federal costs. Thus, the additional step would be to multiply the estimated cost of the state EIC by 1.135.

6. Multiply the estimated state cost by 1.135 to account for the 13.5 percent additional cost, over the cost of the basic credit, associated with the federal supplemental young child and health insurance credits.

Estimating the Cost of Non-Refundable EICs

Estimating the costs of non-refundable credits is more complex. These costs are heavily dependent on the state income tax burdens of prospective EIC recipients. The lower the state income tax threshold and the higher the state income tax burdens on low-income working families with children, the more expensive a non-refundable state EIC will be. For states with higher thresholds and lower income tax burdens on low-to-moderate income working families, establishing a non-refundable state earned income credit can be very inexpensive because there is not much income tax liability to offset.

Federal data is of little use in estimating the cost of a non-refundable credit. The information available from the IRS on EIC claimants by state does distinguish between the portion of the credit that offsets federal tax liability and the portion that is refundable. This information is only useful in the very few states that have an income tax threshold very similar to the federal threshold. In all other states, a state-specific calculation would be required.

States with Income Tax Thresholds Similar to Federal Threshold

In a state *with a tax threshold that is similar to the federal threshold,* the following procedure would yield a *rough* estimate.

A. Divide the amount of non-refund federal EIC benefit[39] received by families in the state in 1989[40] (for example, $34 million) by the total amount of non-refund EIC for the country in the same year (for

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[38] The Joint Committee on Taxation estimates the 1992 cost of the basic benefit will be $9.6 billion, with an additional $1.3 billion for the supplemental benefits.

[39] As used here, the non-refund EIC benefit means the portion of the EIC used by families to offset their tax liability. In the tables in the *Statistics of Income Bulletin,* the portion of the federal EIC used to reduce tax liability is shown as the earned income credit "amount." The portion of the EIC benefit that exceeds tax liability and is refunded to families is called "excess earned income credit."

[40] Or the most recent available year.

example, $2.0 billion). The result is the state's share of the total non-refund federal EIC. ($34 million /$2 billion = 1.7%)

B. Multiply that percentage by an estimate of the total amount of non-refund federal EIC expected to be used nationwide in the coming year. This estimate can be found in federal budget documents. For example, the President's budget estimates this figure will be $3.0 billion in federal fiscal year 1993. This calculation will yield a rough estimate of the non-refund portion of the federal EIC for the state's population in the coming year (although there are some timing differences between fiscal and calendar year). ($3.0 billion X 0.017 = $51 million)

C. Multiply this result by the percentage of the federal EIC at which the state intends to peg its own EIC. This will yield a rough estimate of the state cost. ($51 million X .30 = $15.3 million)

States with Income Tax Thresholds that Differ from Federal Threshold

For a state with a tax threshold that differs from the federal, the best state-specific calculation of the cost of a non-refundable EIC would be derived from a state tax model. Many states have such models, which are routinely used to estimate the cost of proposed legislation by the executive branch, legislative fiscal offices, or fiscal committees of the legislature. If a tax model is not available, a very rough estimate could be made from state historical data on tax collections.

First, determine the most recent year for which state and IRS data are both available. For that year, *follow steps one through three of the procedure presented above to calculate the cost of a* ***refundable*** *credit*. Then:

4n. Calculate the number of eligible state taxpayers.

a. Determine the maximum income for federal EIC eligibility for the year of available data (eg: $19,340 for 1989). Using state data, determine the number of head-of-household and joint filers that have (a) some state tax liability and (b) incomes below this amount.[41] Multiply that number by 57 percent (.57).[42] For

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[41] Some taxpayers with income too low to owe state income tax will nevertheless file state tax returns to obtain refunds of amounts withheld. States' tax data would typically exclude or identify these filers with no tax liability.

[42] Using the 1987 Census data for families with incomes below the EIC threshold, 57 percent of low-income working families had at least one child.

example, if state data show 400,000 head-of-household and joint filing families with incomes below $19,340, the number of potentially eligible families would be 228,000.

b. This number represents families who will be eligible for some amount of state EIC. But this number cannot simply be multiplied by the state proportion of the average federal EIC benefit. Because the state credit will be non-refundable, some families will have state tax liabilities that are too low to use the full amount of credit to which they would otherwise be entitled. To adjust (very roughly) for this problem, calculate the income level at which state tax liability equals half the average state EIC credit (as determined in step 3 of the calculation for the cost of a refundable credit).[43] Subtract 57 percent of the number of people below that income level from the result of part a.

For example, assume state data show an average of three persons per family in this income range. Further assume that the state standard deduction is $2,000 and its personal exemption is $1,000, for a threshold of $5,000 for a family of three, and that the tax rate for families with taxable income just above the threshold is four percent. From step 3, it was determined that the average state EIC benefit would be $146, half of which is $73. The income at which state tax liability equals half the average state EIC may be expressed as "0.04(X - $5,000) = $73" which solves to $6,825. If 100,000 families had income below $6,825, then the estimate of EIC eligible families would be 228,000 - (.57 X 100,000) = 171,000 families.

5n. Adjust for the proportion of eligible families who will receive a federal EIC but not a state EIC[44] by multiplying the result of step 4n by 80 percent. (171,000 X .80 = 136,800) If a state will calculate the EIC for

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[43] Families with state income tax liability below half the average state EIC benefit will receive partial EIC benefits. This calculation matches those partial benefits with the partial benefits received by families with tax liability between half of the average EIC and the full amount of the average EIC. Much like labor statistics, which count two half-time employees as one "full-time equivalent" employee, this procedure roughly counts the EIC "average-benefit equivalent" number of families. This number of families can then be multiplied by the average benefit to yield a cost estimate. In reality, a larger number of families will receive some EIC benefit.

[44] Primarily because the family has had the IRS compute its EIC and so does not know its federal EIC benefit amount to claim on its state tax return.

the family, or intends to use IRS tapes to identify eligible families, this step may be omitted.

6n. Multiply the projected average state EIC benefit by the number of EIC recipients calculated in step 4 or step 5 (eg: $146 x 136,800 = $20 million). The product is the approximate cost of the non-refundable state *basic* EIC. To calculate the cost of the full EIC, with the supplemental young child and health insurance credits, the product should be increased by 13.5 percent as described above (eg: $20 million X 1.135 = $22.7 million).

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